

**MINUTES OF THE REGULAR MEETING OF THE
ARIZONA STATE RETIREMENT SYSTEM BOARD**

**HELD ON
Friday, May 17, 2002
8:30 a.m., MST**

The Arizona State Retirement System (ASRS) Board met in the 10th Floor Board Room of the ASRS office at 3300 North Central Avenue, Phoenix, Arizona 85012. Mr. Jim Bruner, Chairman, Arizona State Retirement System Board called the meeting to order at 8:30 a.m., MST.

The meeting was teleconferenced to the ASRS office, 7660 East Broadway Boulevard, Suite 108, Tucson, Arizona 85710.

1. Call to Order; Roll Call.

Present: Mr. Jim Bruner, Chairman
Ms. Charlotte Borchert
Dr. Chuck Essigs
Ms. Bonnie Gonzalez
Mr. Alan Maguire
Mr. Karl Polen
Mr. Ray Rottas
Mr. Carl Tenney

Excused: Mr. Norman Miller

A quorum was present for the purpose of conducting business.

2. Approval of Minutes of the April 19, 2002, Regular and the May 3, 2002, Special Meetings of the ASRS Board.

Motion: Ms. Bonnie Gonzalez moved to approve the minutes of the April 19, 2002 regular and the May 3, 2002, special meetings of the ASRS Board.

Dr. Chuck Essigs seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, 1 excused, the motion was approved.

3. Board Approval of Consent Schedule.

Motion: Mr. Ray Rottas moved to approve the summary report of Retirements, Refunds and Death Benefits, System Transfers, and Application and Agreements with the following Employer: Chino Valley Fire District.

Ms. Bonnie Gonzalez seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, 1 excused, the motion was approved.

4. Presentation, Discussion and Appropriate Action Regarding the Request for Hearing for Ms. Pauline Johnson.

Mr. Fred Stork, Assistant Attorney General, explained that the ASRS Long-term Disability (LTD) program provides for an offset to the base amount of an LTD recipient's ASRS benefit for compensation the member may receive from other sources. Ms. Johnson receives a Social Security (SS) disability benefit for herself and a SS disability benefit for a dependent. The LTD administrator has interpreted A.R.S. § 38-797.07(A)(1)(a) to allow offsets for both the member's SS disability benefit and that of the dependent. Given the historical application and apparent intent of the statute, Mr. Stork believes the LTD administrator has appropriately applied the offset for the dependent's SS disability benefit.

Ms. Kathryn Petroff, Esq., attorney representing Ms. Pauline Johnson, agreed with the offset for the member's SS disability payment but disputed the validity of the offset for a member's dependent's SS disability payment. She argued that the statute provides an offset for one or the other but not both disability benefits. Ms. Petroff concluded that the language of the statute is vague and historical legislative records do not clarify the Legislature's intent. She stressed that the money from SS is for the dependent's care, and the ASRS program should only offset a dependent's SS disability benefit if it is used for the member's care.

Mr. Alan Maguire asked why the dependent is eligible for SS benefits. Ms. Petroff responded that he is eligible because of the member's disability, and that benefit is for the dependent's care. Mr. Maguire clarified that the ASRS LTD benefit is to compensate a member for the loss of salary because she is no longer able to work. Although the benefit may support both her and her dependent, the purpose of the benefit is to replace lost salary, not to provide care. Ms. Petroff pointed out that the SS benefit for the dependent is paid specifically for the dependent's care. Mr. John Hinderacker, Esq., Legal Counsel retained by the Board to render an independent legal opinion on the appeal, countered that although the SS disability benefit to the dependent may be designated for the child's care, it is a result of the participant's disability.

Mr. Hinderacker noted that the issue is primarily one of statutory interpretation. He agreed that there is scant legislative history, but a 1994 Senate Fact Sheet says the statute was modified for the "determination of ASRS LTD benefits such that 64% of dependent's Social Security benefits are subtracted from the base LTD amount."

Ms. Pauline Johnson arrived at 8:52 a.m. but did not wish to address the Board.

Ms. Petroff requested that the ASRS provide a reason for the need to offset a dependent's benefit and clarify the policy. Mr. Ray Rottas commented that based on the evidence and the testimony, the law is clear as to what the ASRS practice should and must be.

Motion: Mr. Ray Rottas moved to deny Pauline Johnson's request to provide her with the full long-term disability benefits designated for her dependent. The ASRS plan has properly interpreted A.R.S. § 38-797.07 (A)(1)(a) to offset Social Security disability benefits designated for Ms. Johnson's dependent. The Board may not decline to follow a statute.

Mr. Karl Polen seconded the motion.

Mr. Maguire added that he believes the statute is clear and that the legislative documentation supports that interpretation. The fact that the benefit is a replacement for lost salary indicates the purpose of the benefit.

Dr. Chuck Essigs suggested that, although this case is clear on its merit, staff may want to clarify policy for other possible situations. Mr. Carl Tenney agreed that it may be worth clarifying the statute in a future legislative session.

By a vote of 8 in favor, 0 opposed, 0 abstentions, 1 excused, the motion was approved.

5. Presentation, Discussion and Appropriate Action Regarding Economic/Market Overview and Total Fund Performance for the period ending March 31, 2002.

Mr. Terry Dennison, Principal, Mercer Investment Consulting presented an overview of the economy and reported on the ASRS Total Fund Performance for the period ending March 31, 2002.

Total Fund Performance for Periods Ending March 31, 2002

| | Qtr | 1 Year | 3 Years | 5 Years | 10 Years |
|--------------------------------|------------|---------------|----------------|----------------|-----------------|
| Total ASRS Fund | 0.7% | 2.3% | 2.0% | 9.8% | 11.2% |
| Benchmark* | 0.3 | 0.8 | -0.2 | 7.8 | 9.8 |
| TUCS Public Fund Median | 0.8 | 2.2 | 3.3 | 8.5 | 10.3 |

*1/1/89-12/31/91 is 60% S&P 500/40% LB Aggregate.

1/1/95-6/30/97 is 45% S&P 500/40% LB Aggregate/15% EAFE.

1/1/00-Present is 53% S&P 500/30% LB Aggregate/17% EAFE.

1/1/92-12/31/94 is 50% S&P 500/40% LB Aggregate/10% EAFE.

7/1/97-12/31/99 is 50% S&P 500/35% LB Aggregate/15% EAFE, and

Performance vs. Benchmarks for the 3 Years Ending March 31, 2002

| | Return | Assumed ROR | Std.Dev. | Assumed Std. Dev. |
|------------------------|---------------|--------------------|-----------------|--------------------------|
| Total ASRS Fund | 2.0% | 8.4% | 12.2% | 11.8% |
| Benchmark | -0.2 | | 10.9 | |
| Domestic Fixed | 6.4 | 5.6 | 3.8 | 5.3 |
| LB Aggregate | 6.5 | | 3.6 | |

| | | | | |
|------------------------|------|------|------|------|
| Domestic Equity | -0.4 | 9.4 | 18.5 | 16.3 |
| S&P 500 | -2.5 | | 18.0 | |
| Intl Equity | 1.3 | 10.0 | 20.2 | 21.5 |
| EAFE | -5.1 | | 17.3 | |

Performance vs. Benchmarks for the 5 Years Ending March 31, 2002

| | Return | Assumed ROR | Std.Dev. | Assumed Std. Dev. |
|------------------------|---------------|--------------------|-----------------|--------------------------|
| Total ASRS Fund | 9.8% | 8.4% | 13.5% | 11.8% |
| Benchmark | 7.8 | | 12.3 | |
| Domestic Fixed | 7.7 | 5.6 | 3.8 | 5.3 |
| LB Aggregate | 7.6 | | 3.5 | |
| Domestic Equity | 11.2 | 9.4 | 20.3 | 16.3 |
| S&P 500 | 10.2 | | 19.8 | |
| Intl Equity | 6.2 | 10.0 | 21.3 | 21.5 |
| EAFE | 1.6 | | 20.0 | |

6. Presentation, Discussion and Appropriate Action Regarding the Performance of Domestic Large Cap Equity Managers for the Period Ending March 31, 2002.

Mr. Terry Dennison reported on the investment managers' performance for the Arizona State Retirement System (E1), the Arizona State Retirement System (E2), Barclays Global Investors (BGI), JP Morgan Investment Management, Inc., and Mellon Equity for the period ending March 31, 2002.

Mr. Michael Viteri, Portfolio Manager, reported on the Arizona State Retirement System's (E1) performance for the period ending March 31, 2002.

| | Qtr Ending 3/31/02 | 1 Yr | 2 Yrs | 3 Yrs | 5 Yrs | Inception* |
|----------------------------------|---------------------------|-------------|--------------|--------------|--------------|-------------------|
| E1 | 0.44% | 0.38% | -11.15% | -2.61% | 9.76% | 12.53% |
| S&P 500 | 0.28 | 0.24 | -11.39 | -2.53 | 10.18 | 12.68 |
| Actual Alpha/ Value Added | 0.16 | 0.14 | 0.24 | -0.08 | -0.42 | -0.16 |

*From 9/30/95

Mr. Viteri also reported on the Arizona State Retirement System's (E2) performance for the period ending March 31, 2002.

| | Qtr Ending 3/31/02 | 1 Yr | 2 Yrs | 3 Yrs | 5 Yrs | Inception* |
|----------------------------------|---------------------------|-------------|--------------|--------------|--------------|-------------------|
| E2 | 0.29% | 0.29% | -11.32% | -2.39% | 10.35% | 10.35% |
| S&P 500 | 0.28 | 0.24 | -11.39 | -2.53 | 10.18 | 10.18 |
| Actual Alpha/ Value Added | 0.01 | 0.05 | 0.07 | 0.14 | 0.17 | 0.17 |

*From 3/31/1997

Mr. Alan Maguire asked about the cost for managing these portfolios. Mr. Viteri responded that it is approximately 0.85 basis points for each of the portfolios and that the reported returns are net of that.

Mr. Ray Rottas commented, for the benefit of new Board members, that it has been beneficial for the ASRS to have its own investment division so that it understands what is really happening in the market.

Mr. Karl Polen noted that under contracts with other managers, securities lending income is split between the manager and the ASRS and asked how it was handled for internal portfolios. Mr Paul Matson, Chief Investment Officer, responded that no internal portfolio is credited with securities lending. The income goes directly into master cash and is credited to total fund performance only.

Mr. David Lissek, Principal, reported on BGI's performance for the period ending March 31, 2002.

| | Quarter | 1 Year | 3 Years | 5 Years | Inception* |
|------------------------------------------------|----------------|---------------|----------------|----------------|-------------------|
| ASRS Net Return | 0.27% | 0.25% | -2.53% | 10.19% | 12.48% |
| Benchmark Return (S&P 500) | 0.27 | 0.24 | -2.53 | 10.17 | 12.46 |
| Total Value Added Relative to Benchmark | 0.00 | 0.01 | 0.00 | 0.02 | 0.02 |

* Inception: 07/31/1989

Mr. Polen asked about the ownership of BGI and plans for employees to buy it. Mr. Lissek answered that currently the senior executives own up to 13% in holdings, and the plan has been to move that percentage to 20%.

Mr. Henry Cavanna, Portfolio Manager, reported on JP Morgan Investment Management, Inc.'s performance for the period ending March 31, 2002.

| | Quarter * | 1 Year | 3 Years | 5 Years | 10 Years | Inception** |
|------------------------------------------------|----------------------|---------------|----------------|----------------|-----------------|--------------------|
| Sector Selection | -0.08% | -0.67% | -0.13% | -0.40% | 0.19% | 0.01% |
| Stock Selection*** | -3.13 | -0.19 | 1.00 | 1.04 | 1.21 | 1.39 |
| Other**** | 0.09 | 0.22 | 0.35 | -0.41 | -0.28 | -0.13 |
| Fee | -0.04 | -0.14 | -0.14 | --0.14 | -0.14 | -0.14 |
| Total Value Added Relative to Benchmark | -3.16 | -0.78 | 1.08 | 0.09 | 0.60 | 1.13 |

*Not annualized
1991

**July 1, 1987, separate accounts as of January 1,

***Includes interaction

****Includes intra-period trading and cash impact

Mr. Cavanna explained that he believes corporations are focused on the short term right now but the economic environment should change by the end of the year. In the meantime, JP Morgan will adjust its individual stock selection to produce better returns.

Mr. Alan Maguire asked what kind of changes in the economy would change the overall performance and the performance relative to all the Large Cap managers. Mr. Cavanna responded a return to a risk-taking environment, which will happen when corporate earnings, cash flow, and capital investment and spending start improving, would improve performance.

Mr. Matthew Cunningham, CFA, Vice President, reported on Mellon Equity's performance for the period ending March 31, 2002.

| | Quarter | 1 Year | 3 Years | Annualized Since Inception** |
|------------------------------------------------|----------------|---------------|----------------|-------------------------------------|
| Sector Selection | -0.05% | -0.42% | 0.06% | -0.19% |
| Stock Selection | -1.29 | -2.80 | -3.28 | -2.50 |
| Other | 0.57 | 0.74 | -0.26 | -0.09 |
| Fees (%)* | -0.03 | -0.12 | -0.12 | -0.12 |
| Total Value Added Relative to Benchmark | -0.80 | -2.60 | -3.60 | -2.90 |

*All performance is net of fees

**Inception date 7/01/98

Mr. Cunningham noted that because of the timeframe, the ASRS has never benefited from a good performance from Mellon; however, recently Mellon has adapted its model, and in the past six months, the portfolio has performed better than it has in the past few years.

7. Presentation, Discussion and Appropriate Action Regarding the U.S. Equity Mid Cap Request for Proposal (RFP).

Mr. Alan Maguire, Chairman, Investment Manager Evaluation Committee, reported that the committee has moved along in the RFP process and is currently negotiating final contracts. Existing contracts of the U.S. Equity Mid Cap managers expire at the end of May.

Motion: Mr. Alan Maguire moved to extend the contracts of existing U.S. Equity Mid Cap managers until such time as the current proposal evaluation process is completed and new contracts have been executed with the managers selected through that process, provided that such contract extensions do not extend beyond June 30, 2002.

Mr. Ray Rottas seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, 1 excused, the motion was approved.

8. Presentation, Discussion and Appropriate Action Regarding the Issuance of the Active U.S. Equity Large Cap RFP and Postponing the Issuance of the International Equity RFP.

Mr. Karl Polen, Chairman, Investment Review Board Committee (IRBC), commented that the fund has benefited from the selection of active managers, with the exception of managers in the active Large Cap stocks. The committee believes the members of the ASRS are best served if an RFP is issued for Active Large Cap managers now, rather than waiting an additional year.

Motion: Mr. Karl Polen moved to issue the Active U.S. Equity Large RFP as soon as possible and to postpone the issuance of the International Equity RFP until next year.

Ms. Bonnie Gonzalez seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, 1 excused, the motion was approved

9. Presentation, Discussion and Appropriate Action Regarding Modifications to the Procurement Policy and Procedure.

Mr. Polen explained that the ASRS procurement procedure did not specifically provide for on-site visits and interviews of existing and prospective managers. The committee believes such a practice would be beneficial and have adjusted the policy appropriately.

Motion: Mr. Karl Polen moved to approve changes to the ASRS's Policy and Procedure "Acquisition of Professional Services" (FSD012) to explicitly include the ability of the ASRS Board and staff members to conduct on-site reviews of professional service providers.

Mr. Alan Maguire seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, 1 excused, the motion was approved.

10. Director's Report

Mr. Richard Stephenson, Deputy Director, External Operations, reported that HB 2558, which extends the health insurance supplement to members living outside of Arizona, will be voted on in the Senate and is likely to pass.

Mr. Stephenson announced the Mr. Tom Finnerty, Legislative Liaison, will be retiring on May 31. Mr. Finnerty has had many legislative successes, and his knowledge and expertise will be a sincere loss.

Mr. Stephenson also reported that SB 1095 (conforming changes and Return to Work) has been signed by the governor and is effective on signature. Dr. Chuck Essigs asked whether members who have a Payroll Deduction Agreement (PDA) to buy service could change their election and utilize the provisions in the bill. Mr. Fred Stork responded that a PDA is irrevocable and can only be changed if the member stops working. Dr. Essigs requested that information be provided to members in a newsletter as soon as possible.

Ms. Bonnie Gonzalez asked if employers who are audited by the ASRS Internal Audit Department respond to the audit comments. Mr. Bernard Glick, Chief Internal Auditor, answered that the employers are not required to respond.

Ms. Gonzalez recommended that the policy be changed so that the Board can know that the employer has accepted the audit recommendations and made some changes. Ms. Charlotte Borchert added that the State Board of Charter Schools and the State Board of Education also be provided the data. Mr. Jim Bruner asked that the record reflect that it is the recommendation of the Board that the appropriate parties have copies of the audit and that it become standard operating procedure to request a response.

Mr. Alan Maguire requested that a brief presentation on how securities lending works and why it is a positive benefit be placed on a Board agenda in the next few months.

11. Board Requests for Agenda Items

Mr. Jim Bruner requested comments from members of the Board regarding the Board Governance RFP within the next week.

12. Call to the Public.

There were no requests to speak from the Phoenix or Tucson public.

13. The next ASRS Board meeting is scheduled for Thursday, June 20, 2002 at 8:30 a.m. in the Conference Room of the Little America Hotel, located at 2515 East Butler Avenue, Flagstaff, Arizona, 86004.

14. Adjournment of the ASRS Board.

Mr. Jim Bruner, Chairman adjourned the May 17, 2002 meeting of the ASRS Board at 11:32 a.m.

Respectfully submitted,

Maurah Harrison, Secretary

Date

LeRoy Gilbertson, Director

Date